MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

Economic Advisory Council April 2019 Meeting Minutes

April 15, 2019
8:30 am – 3:00 pm
Millennium Challenge Corporation
7th Floor Conference Rooms

Agenda

9:00 am	**Call to Order, Introductions, Adopt By-laws, and Economic Advisory Council Context and Functions** *Cynthia Huger, Vice President, Dept. of Administration and Finance and Head of Agency* *Mark Sundberg, Chief Economist* *Brian Epley, Designated Federal Officer & Economist*
9:20 am	**Session I: Poverty Reduction through Growth: Reinforcing MCC's Core Mission** *Mark Sundberg, Chief Economist* *Shahrokh Fardoust, EAC member, Session Lead*
10:45 am	Coffee Break
11:00 am	**Session 2: Mobilizing private finance for development: What Works and What Mechanisms Should MCC promote?** *Brian Epley, Economist, MCC* *Alan Gelb, EAC member, Session Lead*
12:15 pm	**Working Lunch	Cost Benefit Analysis** *Guest Speaker, Shanta Devarajan, World Bank Senior Director for Development Economics*
1:30 pm	**Session 3: Identifying Analytic Approaches to MCC's Regional Compact Development** *Theresa Osborne, Deputy Chief Economist* *Louise Fox, EAC member, Session Lead*

2:30 pm	**Planning: Issues for next EAC meeting** *Mark Sundberg, Chief Economist*
2:45 pm	**Opportunity for Public Comment**
3:00 pm	**Concluding comments** *Tom Kelly, Acting Vice President, Dept of Policy and Evaluation*
	Meeting Adjorns

Meeting began at 9:00 am Eastern time.

Call to Order

Introductions, Adopt By-laws, and Economic Advisory Council Context and Functions

Mark Sundberg made introductions and thanked the members for their attendance to the first inaugural Economic Advisory Council (EAC) meeting. He then went over the meeting agenda and briefly explained each session's topic and its importance to MCC.

Cynthia Huger, MCC's Vice President for the Department of Administration and Finance and Head of Agency, described the new country partners selected by MCC's Board as eligible for traditional compacts, threshold programs, and concurrent compacts and the need to draw on the member's expertise to face the new challenges and opportunities that lie ahead.

Brian Epley, Economist and designated federal officer (DFO) provided an overview of the EAC bylaws. He proposed the following change: Rather than choosing a single chair to serve for the two-year lifetime of the EAC, MCC proposes a chair be chosen for each session or topic area. The EAC voted to adopt the bylaws as written and with the aforementioned amendment (subject to subsequent MCC review), to which there were no objections. It was also confirmed remote participation fulfills the attendance requirement for EAC members.

Session I: Poverty Reduction through Growth

Reinforcing MCC's Core Mission

Introduced by Mark Sundberg, Chief Economist, MCC

Shahrokh Fardoust, Professor at William and Mary College, session lead.

The session was introduced with a short explanation of MCC's mission and evidence-based approach. Efforts are being made to refine and improve MCC's analytic tools and compact design to enhance the impact of MCC programs on economic growth and poverty reduction. The Session Lead noted that MCC uses some of the best analytical tools available, referencing growth diagnostics and cost benefit analysis. Members also noted that most international development agencies have introduced equity objectives to accompany the economic growth objective into their mission statements: Shared prosperity (World Bank), 'promote equality' (European Investment Bank), 'quality of growth' that is 'inclusive and resilient' (Asian Development Bank). This reflects growing concern across countries with the social impact of high inequality in income distribution and economic opportunity open to poor people.

Several EAC members noted the central role of growth in long term poverty reduction, an issue which is not disputed. However, one member noted that mathematically, as inequality increases, the impact of the same economic growth rate on poverty reduction declines. Various global factors were cited as leading to increased attention to distributional outcomes and the 'quality of growth': the rise in inequality in several countries, concerns over climate change and sustainability of growth patterns, and some emerging evidence suggesting that high inequality can negatively impact growth.

EAC members inquired about the logic of country selection. MCC clarified that it has no regional or sectoral preferences. An EAC member contrasted MCC and USAID in regards to country choice: MCC has a disciplined evidence-based practice it follows for country and sector selection. Country selection includes the use of country scorecards, and sector selection is determined through the data-driven investment decision process.

- Members expressed interest in MCC's country evaluation process and Mark Sundberg suggested this be considered as a topic for future meetings;
- One EAC member suggested that MCC consider using as a country selection criterion an indicator for more egalitarian policies.

EAC members suggested ways in which MCC could strive to be 'ahead of the game' to improve its analytics around linkages between growth and poverty reduction:

- Some EAC members noted that MCC currently examines constraints to growth, but suggested that it may want to consider analyzing inequality and its impact on poverty reduction as well;
- One EAC participant suggested a shift away from MCC's income growth focus to consideration of development more broadly;
- An EAC member suggested that measures to improve distribution can be compatible with growth and important for poverty reduction, and thus, addressing inequality can also help countries grow in a sustained manner over time. In addition, the issue of sustainable growth is affected by environmental and climate change factors;

- A member also recommended that instead of framing the issue of inequality around incomes, that the focus be placed on improving equality of opportunity to highlight the public role in supporting access of the poor to core public services (education, health care, water and sanitation services, etc.) as basic elements of their ability to participate in the economy and achieve their economic potential. This member suggested that MCC should not adopt an explicit measure or target for reducing inequality, but suggested instead that MCC should focus on impacts on the poor;
- One member recommended that MCC can broaden its analysis to target raising incomes of the bottom 40 percent (the shared prosperity metric used by the World Bank, while two EAC members speculated that the cost benefit analysis (CBA) framework can be modified using distributional weights. One suggested assigning positive weight only to the welfare of the bottom 40 percent;
- Another member suggested that new analytic tools, such as fiscal incidence analytics developed at the Commitment to Equity Institute (Tulane University), could contribute to MCC's mission of reducing poverty;
- One EAC member mentioned the importance of accounting for macroeconomic factors that can explain conditions of high growth but no movement in poverty or private consumption per capita, but where distribution is not the core issue. In these cases it is essential to look at the macro situation in order to better understand the micro constraints facing the countries. The member gave the example of aid dependent nations in Africa, wherein aid was invested or spent and could have raised growth in a future period, but that this did not translate to improved real incomes of households in the same timeframe (given the macro source of this growth);
- An EAC member expressed a concern that the five-year time period limits what goals MCC is able to set for its compacts and underscored that the timeframe for analysis of constraints and determinants of growth is important as well. For example, even if policies or aid result in appropriate public investments the impacts on future growth and poverty reduction may not show up in the short term.
- Members advised caution in setting any explicit distributional goals, but members expressed support for MCC's use of the current beneficiary analysis metric.
- One member also noted that if an agency sets as its goal to eliminate poverty, the targeted income floor needs to be raised to the poverty line, noting this is a more ambitious target than current practice;
- An EAC member also suggested greater analytic attention to the issue of disruptive technologies (e.g. block-chain technologies, shifting global value chains, artificial intelligence), which may put a premium on human capital (and potentially reduce opportunities for unskilled workers).

Several more specific suggestions were advanced by individual members of the EAC around the issue of measures to focus more directly on improving the lives of the poor:

- To make power interventions more sustainable, place greater emphasis on renewable energy;
- Place greater attention to the labor market impact on employment generation for the lower income quintiles.
- In regards to education and inequality, both the opportunity of education (enrollment) and the quality of education must be considered. Access alone will not change livelihoods, educational quality, and skills development;
- One EAC member noted that World Bank research has underscored the much greater inequality in distribution of human capital than income inequality, particularly when it is quality adjusted;
- MCC should consider giving greater attention to incidence analysis in the use of Cost-Benefit

models to weight the beneficial impact of interventions on poorer deciles, and more generally on poverty reduction;
- A member noted that CBA benefits are skewed toward income generation, with less emphasis on indirect benefit streams that are more difficult to assess, but may be of greater importance to the poor.

The topic of subnational growth analysis and lagging regions was raised by EAC members in the context of exploring opportunities for MCC to expand in this direction in the future given very large disparities between regions within countries. MCC staff clarified that MCC works nationally and has not targeted compact programs sub-nationally, although there is some prospect for considering this in the future. Some suggestions were made by EAC members in this regard:

- Within-country subnational or regional differences could be an issue for large countries, in which MCC should look beyond national income and poverty to looking at regional differences in price, human capital, environmental endowments, security, etc. Often regional differences are glaring and affect significant population groups;
- Members noted the tradeoffs to measuring the constraint at the national versus subnational level, in which the former may show lower growth impact nationally, but higher rates of return for the poor. If MCC were to pursue subnational compacts these tradeoffs should be explicitly addressed in its analytic modeling;
- Members underscored the need to look at the equity of fiscal policy and the reliability of the country's tax system. Assessment of the incentives and incidence of fiscal policy (both revenues and expenditures) was suggested at the subnational level as well;
- Another member posed the question sometimes asked – that is, why US taxpayer money should be invested in a country that refuses to tax its own citizens, particularly its richer citizens. The member suggested that MCC look at indirect benefits of projects even if the tax system is unreliable.
- An EAC member mentioned that if MCC measures the constraint at the national level, they may see low growth nationally, but higher rate of returns for the poor;
- Related to this point on fiscal policy and resource mobilization, one EAC member suggested consideration of using fiscal effort as an indicator in MCC's scorecard. The point was made that US aid should go to countries with demonstrated tax effort and domestic resource mobilization (adjusted to their income level and capacity).

The session came to a close with a question posed to MCC staff by EAC members: were the suggestions made to MCC feasible in MCC's current institutional context. MCC members responded to say they would certainly be discussed and could report back to the EAC in subsequent sessions.

Session 2: Mobilizing private finance for development

What Works and What Mechanisms Should MCC promote?

Introduced by Brian Epley, Economist, MCC
Alan Gelb, session lead.

MCC introduced the session by noting that there is a new opportunity for MCC to work with the United States International Development Finance Corporation. MCC is currently exploring the potential opportunities for partnering with this new agency. There is the opportunity to leverage MCC's scarce grant funds through blended finance options. [1] The overarching question is what MCC's role should be with blended finance opportunities given that the countries in which MCC works are often relatively high risk and may be constrained by inefficient financial systems.

The session began with a discussion of sovereign bond guarantees, with several members expressing concerns about public financial management in MCC's partner countries, risky levels of sovereign debt, and the additionality of capital flows. These members urged MCC to take these issues into account when thinking about how MCC might encourage capital flow to high risk countries. MCC clarified that it cannot provide sovereign bond guarantees, but MCC can help to crowd-in private capital through blended-finance approaches which insulate investors from risk. One member asked: When a country signs a policy commitment with MCC, what happens if the policy guarantee is not adhered to? MCC suggested that this question may need to be revisited. Members made several recommendations:

- EAC members recommended that MCC take part in policy and reform mitigations to reduce risk. One member underscored the value of market discipline for countries' incentives to improve their risk profiles, and that this discipline can be undermined by external guarantees (e.g., from MIGA or a DFC);
- An EAC member suggested that MCC incorporate lessons from the World Bank Group approach of creating a comparative advantage by partnering with other organizations;
- Another EAC member expressed concern regarding MCC's ability to enforce fiscal discipline in high risk countries, and suggested greater attention to macro risk management in these contexts.

At this point, the discussion turned to project financing, especially with respect to financing in African countries. An EAC member noted that good governance of state-owned enterprises (SOEs) is necessary for attracting private finance so that many African and lower-income nations are unable to obtain financing from the private sector. These governments therefore turn to entities, such as China, that are uninterested in the governance of SOEs. Another member noted that there are dollar-denominated Chinese loans that are of inadequate duration for many large projects, and pose financing risks to the borrower.

MCC noted that there may be an opportunity to develop the capacity to mobilize domestic currency finance, which may involve less risk from a macroeconomic standpoint. A member noted that there is a need to remember that the issue with blended finance are on the backend – on the accounting and reserve requirements – rather than the pricing and that the goal is to lower the cost of entering certain markets.

Equity concerns were also raised. A member noted that a World Bank Group project evaluation had looked at the impact on distributional outcomes: while the project was successful on the private sector side, the direct benefits may not flow to the poor because the increase in service charges may result in no increase in their direct usage of services. In these instances, the member suggested that the poor receive a subsidy (if an equivalent lump sum transfer is not possible) to compensate.

Other members provided recommendations for MCC:

- One EAC member stressed the need to know who is paying for projects (national/local government) and how funding and risks are shared among the parties to a PPP. Awareness of these details helps to avoid too much risk being placed on the public sector;
- An EAC member suggested that MCC look further into its relationship with the DFC and what safeguards are necessary. This may include thought on topics of affordability and pricing, equity, and the finance chain. In terms of the DFC, it is important to think about how much risk the US government is willing to tolerate and whether the new DFC will fund projects in lower-income countries that may be less financially attractive, outside the tourism sector.

Working Lunch | Cost Benefit Analysis

Shanta Devarajan, *World Bank Senior Director for Development Economics, Guest Speaker.*

The presentation by Shanta Devarajan on cost-benefit analysis (CBA) and its use as a tool for project selection, began with the question: Why is CBA needed? The discipline of CBA forces us to look at the welfare implications of potential projects. This is crucial because there is a margin on which additional provision of a "good" is not worth the resources devoted to it and would therefore reduce social welfare.

Shanta then asked how CBA can be done so that it is impactful in decision making. He stressed that nothing matters unless CBA can change incentives in donor agencies away from pushing lending, which he believes has become a more serious problem in recent years. Economists have tried to simplify the CBA methodology as much as possible, so that it can always be done.

He identified the counterfactual as a key element of CBA construction and project decision-making. The counterfactual (without-project scenario) which is compared to the with-project scenario so that the changes can be attributed to the project, acts as a disciplining device. Establishing the counterfactual requires an understanding of the underlying market failure so that projects are evaluated on whether they address that failure: It is important to understand where the distortion is and why the private sector has not addressed it. Looking at the counterfactual from a view of market failures needs to be a cornerstone of project development and CBA. If the project provides a public good that the market will not, then the discussion needs to be framed around why the private sector will not provide the good.

Shanta asked a final question: how do you measure the gap between the social benefit and the private benefit? Traditionally with CBA, the process is to identify inputs and outputs, put a shadow price on these quantities and take the difference. But identifying the inputs which generate outputs is a bigger problem than comparing inputs and outputs. Policy change – such as road funds – are one example. Consider the world with and without the policy change, taking the project as given. For example, a road fund would strengthen the link between road investments and transportation services.

Shanta concluded by noting that there aid fungibility creates a dilemma for the CBA construction and project designers, since it undermines the credibility of the counterfactual, which is critical for CBA modeling, and raises the question: what is aid really financing? Additionally, from the receiving governments' point of view, development agencies prefer to fund the cleanest or shiniest projects. This may incentivize governments to present their *best* projects with the intent to use some of the funding on other projects that are not visible to the development agencies.

Following Shanta's presentation, several MCC participants and EAC members discussed his points:

- MCC staff noted that CBA practice can put economists and operational staff at odds since projects have to clear a 10 percent hurdle rate. Staff also commented that MCC struggles with what is reasonable in project design and outcome given the limited 5 year implementation period;
- One MCC staff asked: How successful have economists/project proponents been in specifying or pinpointing precisely what market failure is present in a given instance?
    - Shanta stated that there are in very general terms two main kinds of market failures: public goods and externalities. The tricky thing is in assessing second best situations, in which the market failure in one area causes a distortion in another. Thus, it is important to force the discussion to what the underlying market failure is that causes the distortion;
    - He also said to be explicit with MCC's definition of public goods and to make sure MCC's partners are on the same page.
- EAC members agreed that fungibility of aid poses a quandary for CBA, e.g. if project or sector support would be provided even without donor support (i.e. no direct additionality). Evidence suggests project financing is not highly fungible (the 'fly paper' effect), but partial fungibility may be a concern. One EAC member suggested considering a sector-wide view beyond the individual MCC investment to understand where assistance is flowing historically and consider evidence for aid additionality in that context.

Session 3: Identifying Analytic Approaches to MCC's Regional Compact Development

Analyzing and Prioritizing Obstacles to Regional Integration.

Introduced by Theresa Osborne, Deputy Chief Economist
Louise Fox, session lead.

MCC's economic analysis process and model is currently geared to a single country compact. Engaging in regional compacts gives MCC the opportunity to have a new constraint analysis process; however, it is not practical to ask what is binding to growth on a regional scale. The question proposed is how do we prioritize our constraint analysis and what analytical approaches should we employ keeping in mind the time constraint? Currently MCC is exploring regional project opportunities across five country partners in West Africa selected by the MCC Board as eligible for a concurrent regional compact. Key points and suggestions from the session are as follows.

EAC Members Acknowledged Key Difficulties of Achieving Results

through Concurrent Regional Compacts

EAC members noted that taking a regional approach to growth is very difficult, in part because, as one EAC member noted, countries' domestic priorities will usually take precedence over regional priorities. In addition, as one member observed, regional bodies typically do not have sufficient political authority to implement a regional integration agenda. An EAC member noted that progress will therefore be greater and faster if there is the financial incentive for countries to work together. One member also mentioned that not all countries benefit the same from economies of scale and the overall distribution of benefits will differ adding to difficulty of measurement and CBAs.

On MCC's Approach to Prioritization

Overall, EAC members suggested that MCC not compromise its existing standards and principles, including regarding prioritization of high impact interventions. That is, regional projects should require a Constraints Analysis (CA) or CA-type of analysis at both the country and regional level. Another EAC member echoed this and added that MCC needs to find a sensible way of maintaining its model in regional compacts that it can defend. The member also suggested that MCC could adapt its model through the creation of a regional scorecard. An EAC member said that MCC should count the benefits flowing to countries outside those impacted by the current regional compacts (which would be departure from MCC's existing practice for single country compacts).

In discussing whether there may be sectors or dimensions of regional integration on which to focus MCC's attention a priori, an EAC member advised MCC to address the issue of connectivity in its regional projects to ensure people who are cut off from resources and markets get integrated into the growth process. He suggested that it was reasonable for MCC to look into regional projects in infrastructure and electricity. Another EAC member suggested that MCC help countries to harmonize their standards and policies. He gave the example of labor mobility.

Another EAC member mentioned regional trade as an area of focus; however, several EAC members noted that trade liberalization or facilitation is very complicated to achieve. EAC members listed the following concerns:

- Benefits from trade may be limited due to the production of similar products within poor regions.
- Bilateral trade agreements entail preferential trade. MCC needs to check whether countries have a trade agreement with the EU.
- Lastly, an investment in trade does not necessarily equate to an increase in trade.

Finally, an EAC member suggested MCC discuss experience with World Bank staff who were experienced in developing and implementing regional programs.

Planning: Issues for the next EAC meeting

Mark Sundberg suggested that the second EAC meeting could aim for October, timed around the IMF-World Bank annual meetings which brings people to Washington DC. It was agreed that a few possible options be circulated soon to identify a convenient time and beginning planning ahead.

Future topics for EAC discussion were solicited from members and MCC, yielding the following potential topics:

- Implications of public services and utilities cost recovery for equity outcomes;
- MCC's use of Impact Evaluation: How to better structure the economic logic that underpins MCC's analysis and interface with the project design, and prioritizing learning opportunities;
- Results-based financing (RBF) incentive frameworks and whether additional RBF instruments could be valuably deployed by MCC;
- Experience with 'Problem Driven Iterative Adaptation' approaches, including using MCC analytic instruments (e.g. CBA, beneficiary analysis) in a Problem-Driven Iterative Adaptation (PDIA) framework with high ex ante uncertainty over intervention design;
- Issues related to the cost-benefit methodology: How to embed in project design, MCC's use of discount rates and aspects of labor demand outside the constraints analysis;
- The introduction of inequality into MCC's rationale and structure: What does MCC look for in its use of the constraints diagnostics and country scorecard?

Members then made some suggestions for structuring the next meeting. One MCC staff, who was participating in the meeting, said it would be helpful if MCC could give a summary of its successes over the last decade: What has been done and what has been learned. Another MCC staff, participating as a member of the public, suggested that the STAR Report already presents what works, what changed and why, over the course of a compact and directed members to visit the MCC website which includes these and other publicly available reports.

Opportunity for Public Comment

One MCC staff member, participating as a member of the public, commented on the constraints to the project design of current regional compacts and the difficulty this presents to MCC. He asked the EAC members two questions, which will be addressed at the next EAC meeting: What is achieved by introducing greater product diversification in countries so they are less vulnerable? And, how does MCC identify the incentives that allow greater integration of trade economies into its concurrent regional compacts?

Concluding comments

Mark Sundberg made concluding remarks. He noted that MCC is celebrating its 15^{th} year and that its model has now been in place for more than a decade. The EAC is well placed to help MCC think through how it will look and what it will aspire to be in another decade? What will "MCC version 3.0" look like? He thanked everyone for their attendance.

MCC Economic Advisory Council Members Present

- Emmanuelle Auriol, University of Toulouse
- Pedro Carneiro, University College London
- David Dollar, Brookings Institution
- Shahrokh Fardoust, College of William and Mary
- Louise Fox, US Agency for International Development
- Alan Harold Gelb, Center for Global Development
- Nora Lustig, Tulane University
- Martin Ravallion, Georgetown University
- Vinod Thomas, National University of Singapore*
- Michael Woolcock, The World Bank

* via Webex

MCC Economic Advisory Council Members Absent

- Matthew Andrews, Harvard University
- Robert N. Stavins, Harvard University
- David Robalino, McKinsey
- Célestin Monga, African Development Bank Group

Endnotes

1. MCC has limited blended finance experience in public-private partnerships (PPPs) and grant facilities. MCC has also provided technological support for countries to development their own PPPs and blended finance institutions.